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STATE OF HAWAII — DEPARTMENT OF TAXATION  
**Instructions for Schedule D**  
**(Form N-35)**  
**Capital Gains and Losses and Built-In Gains**

Section references are to the Internal Revenue Code, unless otherwise noted.

### Purpose of Schedule

Schedule D (Form N-35) is used by S corporations to report sales or exchanges of capital assets and gains on distributions to shareholders of appreciated assets that are capital assets (hereafter referred to as distributions). In addition, this schedule is intended to partition the "flow-through" of an S corporation's net capital gain to its shareholders and to attribute the gain applicable to Hawaii sources. It will directly assist the shareholders of the corporation in properly reporting such gains for the period.

If the corporation elected to be a Hawaii S corporation before 1987 (or made the election during 1987 or 1988 and qualifies for the transitional relief from the built-in gains tax), and had net capital gain (line 17) of more than \$25,000, it may be liable for a capital gains tax on the gain in excess of \$25,000. The tax is figured in Part III of Schedule D.

Generally, if the corporation elected Hawaii S corporation status after 1986, was a C corporation at the time it made the election, and has net recognized built-in gain as defined in section 1374(d)(2) on assets attributable to Hawaii, it is liable for the built-in gains tax. Assets are attributable to Hawaii if they are physically located in Hawaii, are used in a Hawaii business, or if, in the case of intangible assets, the S corporation has its commercial domicile in Hawaii. The tax is figured in Part IV of Schedule D. Sales, exchanges, and distributions of property other than capital assets, including property used in a trade or business, involuntary conversions (other than casualties or thefts), and gain from the disposition of an interest in oil, gas, or geothermal property should be reported on Schedule D-1, Sales of Business Property, see the instructions for Schedule D-1. If property is involuntarily converted because of a casualty or theft, use federal Form 4684, Casualties and Thefts.

### Capital Asset

Each item of property the corporation held (whether or not connected with its trade or business) is a capital asset **except**:

- Stock in trade or other property included in inventory or held mainly for sale to customers.
- Accounts or notes receivable acquired in the ordinary course of the trade or business for services rendered or from the sale of stock in trade or other property held mainly for sale to customers.
- Depreciable or real property used in the trade or business.
- Certain copyrights, literary, musical, or artistic compositions; letters or memorandums; or similar property. See section 1221(3).
- U.S. Government publications, including the Congressional Record, that the corporation received from the Government, other than by purchase at the normal sales price, or that the corporation got from another taxpayer who had received it in a similar way, if the corporations basis is determined by reference to the previous owner.

### Parts I and II

Generally, report sales and exchanges (including like-kind exchanges) even if there is no gain or loss. In Part I, report the sale, exchange, or distribution of capital assets held one year or less. In Part II, report the sale, exchange, or distribution of capital assets

held more than 1 year. Use the trade dates for the dates of acquisition and sale of stocks and bonds on an exchange or over-the-counter market.

For more information, see federal Publication 544, Sales and Other Dispositions of Assets, and federal Publication 589, Tax Information on S Corporations.

**Exchange of like-kind property.**—Complete and attach federal Form 8824, Like-Kind Exchanges, to the corporation's return for each exchange. Also, report the exchange of like-kind property on Schedule D or on Schedule D-1, whichever applies. Report it even if no gain or loss is recognized when business or investment property is exchanged for property of like-kind. For exceptions, see federal Publication 544.

Enter the gain or loss from federal Form 8824 in column (f) and in column (g) if the property traded was Hawaii property. Write in the top margin of Schedule D "Like-Kind Exchange" or if the exchange involved a related party, write "Related Party Like-Kind Exchange."

### Special Rules for the Treatment of Certain Gains and Losses

Capital gain income received from stock acquired through stock options or warrants from a qualified high technology business by an investor who qualifies for the high technology business investment tax credit that would otherwise be taxed as capital gains to those persons is exempt from taxation. Sales of this stock should be reported on line 1 or line 8, as appropriate. Total capital gains are then reduced by the qualifying capital gains on line 4 or line 11.

See the instructions for federal Schedule D (Form 1120S) for a discussion of special rules for the treatment of certain other gains and losses.

### How to Determine the Cost or Other Basis of the Property

In determining gain or loss, the basis of property is generally its cost (see section 1012 and related regulations). Special rules for determining basis are provided in sections in subchapters C, K, O, and P of the Code. These rules may apply to the corporation on the receipt of certain distributions with respect to stock (section 301), liquidation of another corporation (section 334), transfer to another corporation (section 358), transfer from a shareholder or reorganization (section 362), bequest (section 1014), contribution or gift (section 1015), tax-free exchange (section 1031), involuntary conversion (section 1033), certain asset acquisitions (section 1060), or wash sale of stock (section 1091). Attach an explanation if you use a basis other than actual cash cost of the property.

If the corporation is allowed a charitable contribution deduction because it sold property to a charitable organization, figure the adjusted basis for determining gain from the sale by dividing the amount realized by the fair market value and multiplying that result by the adjusted basis.

See section 852(f) for the treatment of certain lead charges incurred in acquiring stock in a mutual fund with a reinvestment right.

Before making an entry in column (e), increase the cost or other basis by any expense of sale, such as broker's fees, commissions, option premiums, and state and local transfer taxes.

### Part III—Capital Gains Tax

If the net long-term capital gain attributable to Hawaii

assets is more than the net short-term capital loss attributable to Hawaii assets, there is a net capital gain attributable to Hawaii assets (net capital gain). If this gain exceeds \$25,000 and the corporation elected to be a Hawaii S corporation before 1987 (or made the election during 1987 or 1988 and qualifies for the transitional relief from the built-in gains tax), the corporation may be liable for income tax on the gain.

By answering the following questions, it can be determined whether the corporation is liable for the tax. If answers to questions A, B, and C are "Yes," the tax applies and Part III of Schedule D must be completed. Otherwise, the corporation is not liable for the tax.

If net capital gain is more than \$25,000 and the corporation is not liable for the tax, answer questions A through C below as an explanation of why it is not liable for the tax.

- A.** Is net capital gain (line 17, Schedule D (Form N-35)) more than \$25,000 and more than 50% of taxable income (line 21, Schedule D (Form N-35))? ..... ☐ Yes ☐ No
- B.** Is taxable income (line 21, Schedule D (Form N-35)) more than \$25,000? ..... ☐ Yes ☐ No
- C.** Does any long-term capital gain (line 16, Schedule D (Form N-35)) represent gain from substituted basis property (defined below)? ..... ☐ Yes ☐ No

For purposes of the capital gains tax, **substituted basis property** is property that:

**1.** Was acquired by the S corporation during the period that began 36 months before the first day of the tax year and ended on the last day of the tax year, and

**2.** Has a basis determined by reference to the basis of any property in the hands of another corporation, if the other corporation was **not** an S corporation throughout the period that began the later of:

- a.** 36 months before the first day of the tax year, or
- b.** The time the other corporation came into existence, and ended on the date the other corporation transferred the property used to determine the basis of the property acquired by the S corporation.

If the answer to question C is "Yes" and the tax is applicable, multiply the net capital gain from property described in question C (reduced by any excess net passive income attributable to this gain—see instruction for line 17) by 6.4%. If this amount is less than the tax figured on line 22, enter this amount on line 23 and write to the right of the amount, "Substituted basis." Attach the computation of the substituted basis amount to Schedule D. (See section 1374(c)(3) as in effect before the enactment of the Tax Reform Act of 1986.)

**Line 17**—If the corporation is liable for the tax on excess net passive income (Form N-35, page 1, line 22a) or the built-in gains tax and capital gain or loss was included in the computation of either tax, figure the amount to enter on line 17 as follows:

**Step 1**—Refigure lines 1, 2, and 8 through 15 of Schedule D by:

- (a)** excluding the portion of any recognized built-in

capital gain or loss that does not qualify for transitional relief, and

- (b) reducing any capital gain taken into account in determining passive investment income by the portion of excess net passive income attributable to such gain. The portion so attributable is figured by multiplying excess net passive income by a fraction, the numerator of which is the amount of the capital gain (less any expenses attributable to such gain), and the denominator of which is net passive income.

**Step 2**—Refigure lines 7, 16, and 17 of Schedule D using the amounts determined in Step 1.

**Line 21**—Figure taxable income by completing lines 1 through 10 and 1 through 12 of Schedule J of Form N-30, Hawaii Corporation Income Tax Return. Enter the amount from Schedule J, line 12 that is attributable to Hawaii on line 21 of Schedule D. Attach to Schedule D the Form N-30 computation or other worksheet used to figure taxable income.

**Line 22**—Figure the corporate income tax based on the taxable income on line 21 as if the S corporation were a C corporation and enter the tax on line 22. You may use Schedule J of Form N-30 to make your computation. Attach your tax computation to Schedule D.

## Part IV—Built-In Gains Tax

Section 1374 provides for a tax on built-in gains that applies to certain corporations that made the election to be an S corporation after 1986. This tax does not apply to any corporation that has been an S corporation for each of its tax years, unless the corporation acquired an asset with a basis determined by reference to its basis (or the basis of any other property) in the hands of a C corporation.

### Transitional Relief from Built-In Gains Tax

See the instructions for federal Schedule D (Form 1120S) for a discussion of special transitional relief from the built-in gains tax for qualified corporations.

**Line 24**—Enter the amount that would be the taxable income of the corporation for the tax year if only recognized built-in gains (including any carryover of gain under section 1374(d)(2)(B)) attributable to Hawaii and recognized built-in losses attributable to Hawaii were taken into account.

See the instructions for federal Schedule D (Form 1120S) for definitions of recognized built-in gain and recognized built-in loss.

A qualified corporation must show on an attachment to Schedule D its total net recognized built-in gain attributable to Hawaii and also list separately the gain or loss attributable to Hawaii that is: (1) gain or

loss from capital assets held 6 months or less and (2) gain or loss from assets for which the disposition results in ordinary income or loss. A nonqualified corporation must show on an attachment its total net recognized built-in gain attributable to Hawaii and list separately any capital gain or loss and ordinary gain or loss.

**Line 25**—See the instructions for line 21. Enter the amount computed on line 25.

**Line 26**—Do not enter on line 26 more than the excess (if any) of the net unrealized built-in gain attributable to Hawaii over the net recognized built-in gain attributable to Hawaii for prior years. This is the amount that should have been entered in item 11 on Form N-35, page 2. See section 1374(c)(2). If, for any tax year, the amount on line 24 exceeds the taxable income on line 25, the excess is treated as a recognized built-in gain attributable to Hawaii in the succeeding tax year. This carryover provision applies only in the case of an S corporation that made its election to be an S corporation on or after March 31, 1988. See section 1374(d)(2)(B).

**Line 27**—Enter the section 1374(b)(2) deduction. Generally, this is any net operating loss carryforward attributable to Hawaii or capital loss carryforward (to the extent of net capital gain included in recognized built-in gain for the tax year) attributable to Hawaii arising in tax years for which the corporation was a C corporation. For details, see section 1374(b)(2).